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US dual real estate market



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US DUAL REAL ESTATE MARKET

Prices across US real estate subsectors have diverged since the Federal Reserve tightened monetary policy. In this edition of Infocus, Senior Economist GianLuigi Mandruzzato looks at the factors driving the US real estate sector and the possible implications for growth and financial stability.

US real estate prices have historically exhibited similar trends across subsectors, mainly reflecting growth and monetary policy cycles. However, since the Federal Reserve began raising interest rates in 2022, prices have diverged between the residential and commercial real estate sectors.

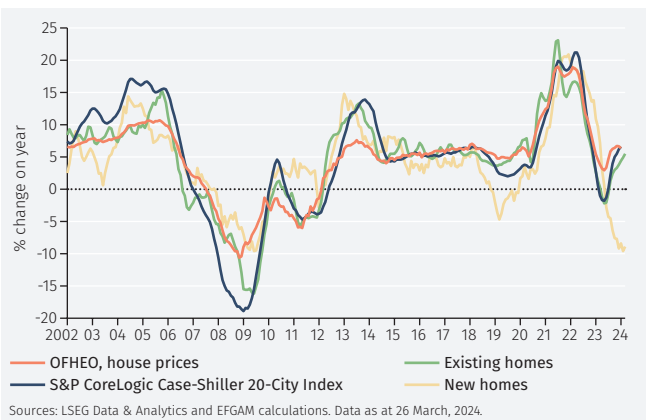
Recent price trends

In the residential real estate (RRE) sector, prices have continued to rise despite restrictive monetary policy (see Figure 1a). After a period of moderation following the first interest rate rises, price increases have regained momentum. The exception is new home prices, which represent around 10% of transactions and which have been decreasing for several months.

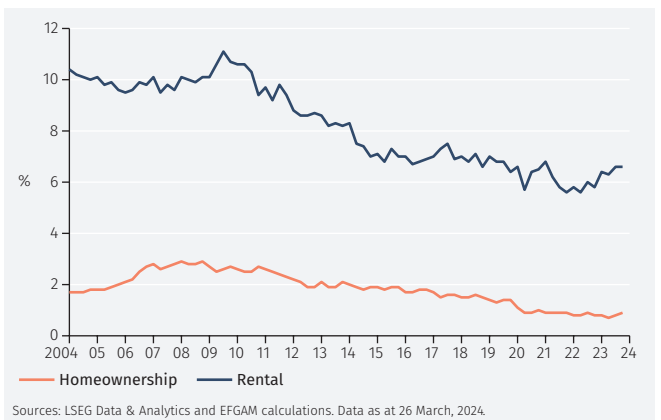
In contrast, since early 2023, prices in the commercial real estate (CRE) sector have been falling (see Figure 1b). Many observers fear that this will affect the rest of the financial system, as was the case during the 2007-09 crisis. The office sector has seen price declines exceeding 15% year-on-year. Retail space and rental apartments have also seen large price drops, although the trend appears to have reversed recently. In contrast, prices of industrial and logistics sectors have held up.

The divergence between RRE and CRE prices reflects supply and demand differences in the two sectors. At the end of 2023, the availability of residential properties for purchase or rental was historically low (see Figure 2a). In contrast, office

1a. House prices



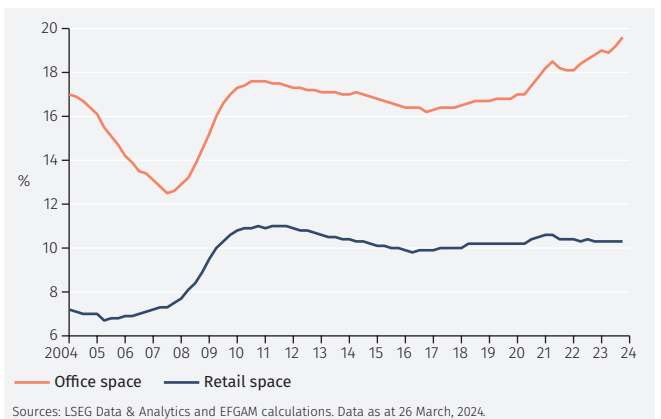
2a. US residential property vacancy rates



1b. Commercial real estate prices



2b. US commercial property vacancy rates



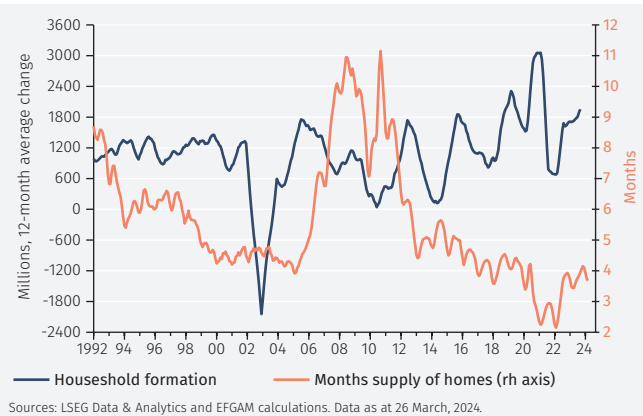
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sector vacancies were almost a fifth of the total (see Figure 2b). In the retail sector, where weakness in demand had emerged well before the pandemic, vacancies have stayed above 10% for over a decade.

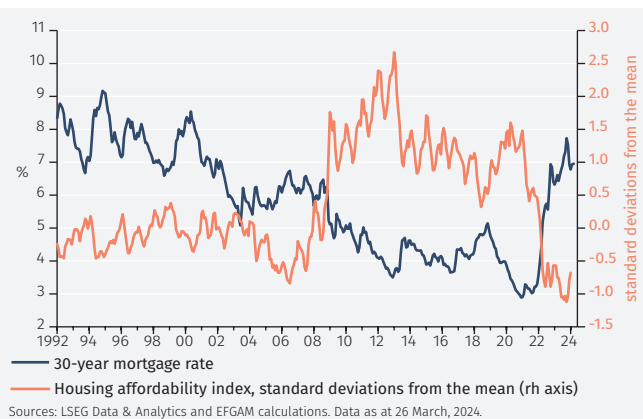
The outlook for residential real estate

The outlook for activity and prices in the RRE sector remains favourable, supported by positive demographics and pandemic-driven changes in US households' preferences (see Figure 3a). Strong employment growth and new household formation support housing demand. At the same time, supply is low, reflecting the adverse impact of the pandemic on the construction sector workforce and increased input prices and financing costs.

3a. Household formation and homes for sale



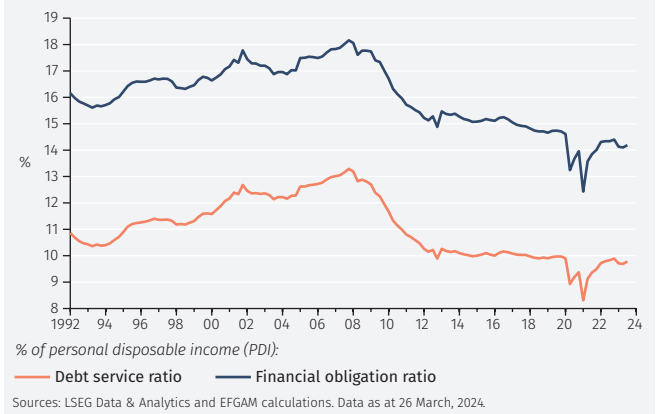
3b. Mortgage rate and housing affordability



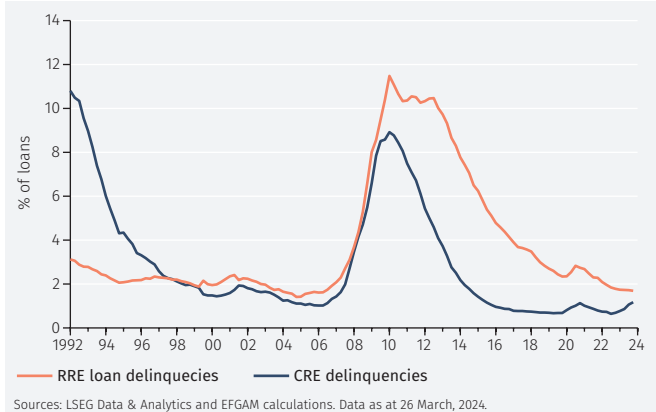
It therefore seems unlikely that house prices and rents will fall much in the near term, despite mortgage rates having risen to a 24-year high, depressing housing affordability (see Figure 3b). That household debt service and financial

obligation ratios are close to the lows since the early 1980s supports the outlook for RRE (see Figure 4a).¹

4a. Households' financial obligations (% of PDI)



4b. US real estate loan delinquency rates



The outlook for commercial real estate

The outlook for the CRE sector is multifaceted. Projects related to the production and logistics sectors will benefit from the fiscal measures introduced by the Biden administration, such as the Inflation Reduction Act, to stimulate US industrial production. The need to improve supply and distribution networks following the growth of online purchases at the expense of in-store purchases, will increase demand in the logistics and infrastructure sector.

The office sector remains the most vulnerable, especially in non-prime locations.² The pandemic-driven structural decline in demand for office workspace, reflecting the shift to employees working from home and the subsequent rise of hybrid workplaces, led to declining occupancy rates. Furthermore, the growing preference for living further from

¹ The debt service ratio measures the share of households' after-tax income obligated to debt repayment, including interest and principal. The financial obligations ratio considers also rent payments on tenant-occupied property, auto lease payments, homeowners' insurance, and property tax payments.

² In the US, locations such as Miami registered growth in office lease rents. Across North America, average gross rents for prime stock continued to rise, increasing by 0.5% in the past six months. Source: <https://www.cbre.com/insights/global-office-rent-tracker>, and Savills, Nov 2023: <https://www.savills.com/impacts/market-trends/savills-prime-office-costs-q3-2023.html>

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urban centres makes central locations or locations far from transport networks less attractive.

Finally, the retail sector will remain under pressure due to the growing trend of consumers making purchases online. Even if the stability of economic growth helps to reabsorb part of the unused commercial spaces, it will take time before demand is sufficient to stimulate a price increase.

The risks to the banking sector

Despite falling prices, at the end of 2023 delinquency rates on all bank loans linked to CRE were only 1.2%. While this rose from a year before, it was far from the 2007-09 peak (see Figure 4b). However, there are concerns that high vacancies in retail and office spaces could lead to a significant increase in default rates, jeopardising the stability of the US banking sector as happened after the residential real estate bubble burst in 2007.

Comparing current market conditions to 2007 highlights some key differences. The US banking sector's exposure to retail and office sectors is less than 8% of total assets, while in 2007 residential mortgages represented almost a fifth of banks' total assets (see Figure 5a).³ Relative to US banks' aggregate net capital, the exposure to office and retail CRE is less than 80% while in 2007 residential mortgages were close to 300%. At an aggregate level, exposure to office and retail CRE appears manageable for the US banking sector.

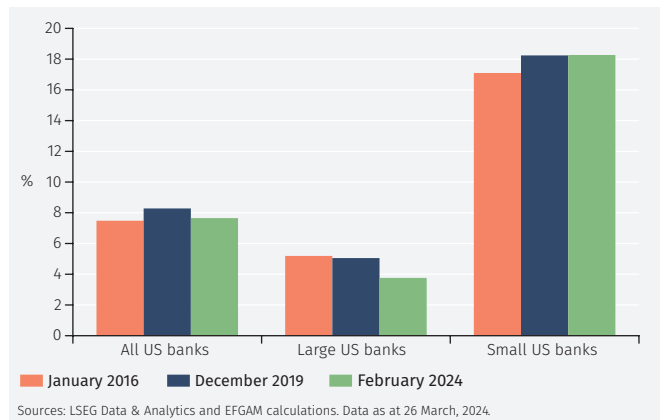
However, the breakdown by size of US banks highlights the risks to smaller institutions. The small banks' exposure to retail and office CRE is approximately five times higher than that of the top 25 US banks (see Figure 5a). Furthermore, while large banks have reduced CRE related balance sheet risks relative to before the pandemic, small banks have made fewer reserve provisions and remain heavily exposed to risks deriving from a possible escalation of the US commercial real estate crisis (see Figure 5b).

Conclusions

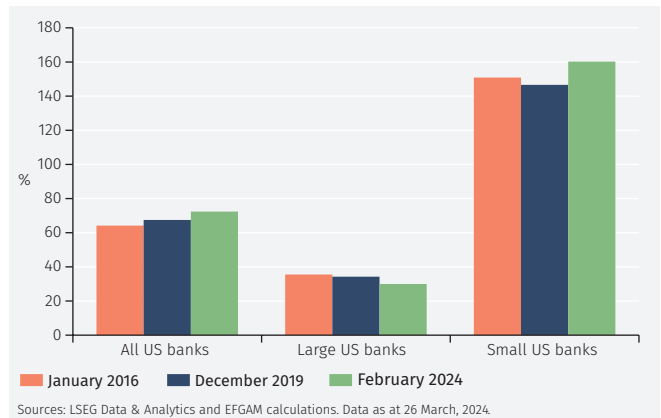
To conclude, after the pandemic, developments in the US real estate sector have reflected both cyclical drivers, such as the increase in Federal Reserve interest rates and strong employment growth, and structural changes, such as the diffusion of online purchasing and work-from-home habits. The outlook for activity and prices remains favourable to the residential sector and commercial sectors linked to industry and logistics.

The greatest concern relates to the office and retail sectors, where high vacancy rates will keep prices under pressure and

5a. Share of office & retail CRE loans in total assets



5b. Ratio of office & retail CRE loans to capital and reserves



could push delinquencies higher. The risks to the stability of the US banking system appear manageable at an aggregate level, but the concentration of exposure among small, regional banks deserves close monitoring.

³ The US 25 largest banks represent approximately 60% of the total assets of the US banking system.

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